DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92038

36 Letters per Year – $125 Annually

Registered with the Securities Exchange Commission

June 20, 1975 Letter 634

June 6, DJIA 839.64; PTI 358; A-D ratio -26.70
June 13, DJIA 824.47; PTI 363; A-D ratio -27.09

THE MARKET: Robert Rhea, the great Dow Theorist of the 1930's, used to say that "the story is in the Averages." I would add that there are times (often extended periods) when the Averages say little or nothing, and there are other periods where the words are loud and clear. We have been in a "mute area" for about six weeks, but I believe the Averages could start talking any day now.

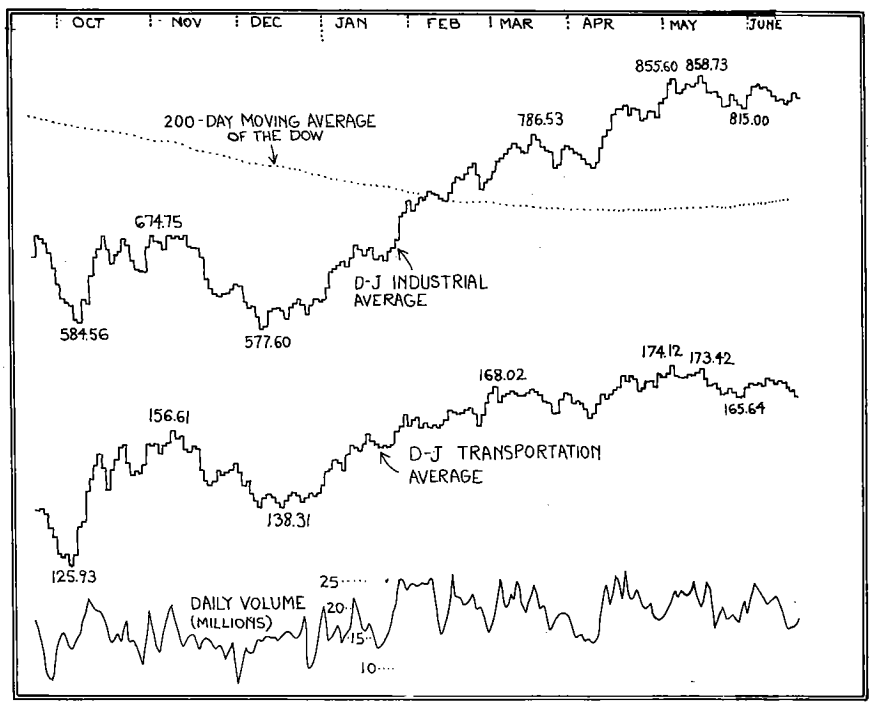
Note on the daily chart below, that the last confirmed highs for the two Averages occurred on May 5, with Industrials at 855.60 and Transports at 174.12. A minor decline followed, and the two Averages rallied again. On May 14 Industrials rose to a new 1975 high of 858.73, but this new peak was unconfirmed by Transports. The market promptly sold off to the late May lows of 815.00 for Industrials, 165.64 for Transports.

Thus we have the two sets of boundaries, 858.73 and 174.12 on the upside, and 815.00 and 165.64 on the downside. A joint penetration of either set of boundaries will determine the next direction of the intermediate (secondary) trend. But remember, "it takes two to Tango," and it takes a movement by both Averages through preceding points to provide authoritative indications of market direction. A penetration of one Average, unconfirmed by the other, is more often than not deceptive. At this juncture I rate the primary trend of the market as bullish, the secondary trend as inconclusive, and the short-term (daily) trend as probably bullish.

Next, I want to offer some comments about volume. The old Wall Street adage runs, "It takes volume to put stocks up, but they will fall of their own weight." To put it another way, it takes aggressive buying to send stocks higher, but in the absence of buying power stocks tend to slip as the bids are lowered and the sellers settle for the lower bids.

Nevertheless, there are many spots in the market (particularly during bull markets) where the strength of weakness of the structure is tested by what I call token penetrations. For instance, if the 815.00 (Industrials) and 165.64 (Transports) lows are jointly broken, it will be most important to see if (1) volume expands on the penetrations, and (2) whether there is downside follow-through. If volume tends to dry up as one or even both Averages break the May lows it will signify an absence of selling pressure, and the situation may still be all right. But if a breaking of the 815.00 and 165.64 lows brings on rising volume and a downside follow-through, then I think we are in for real trouble.

Nothing is more frustrating or difficult than waiting while the Averages fluctuate and meander between two sets of secondary points. Guessing which sets of points will ultimately be broken is just that — guessing. You want my guess? It is that the odds favor a top being formed here, and that in due time the market will correct. But remember, the market usually offers many deceptions before the main course is served.



A few subscribers have written to ask me why I think the "buying panic" ended so suddenly on March 17 (see Letter 626) and what I think the problem is for Wall Street now. My feeling is that the Averages are now appraising the business and profits potential for 1976. This year (1975) has been written off as history already. Profits (after taxes) will be down perhaps as much as 20%, and business appears to be groping for a bottom. But the question on the stock market's mind is whether 1976 is going to represent a year of real profit improvement. If it is, then the worst we

should see here is a normal to mild correction or a sideways "line" in the Averages. If 1976 is going to bring on a continuation of the profit squeeze, then the market is going to head a good deal lower than most investors are prepared for. Either way, I do not see the bull market's ending, but a major secondary here could present pain for many, opportunities for others.

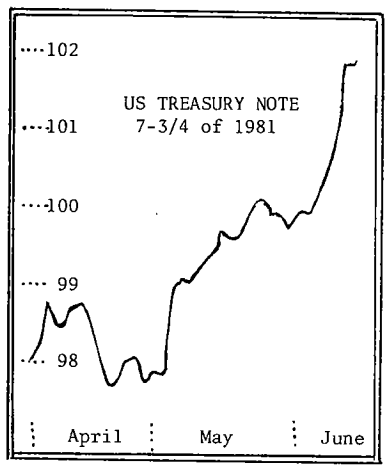
THE PICTURE: In recent Letters I have been saying that in my opinion, the business recovery is not soon going to develop into the steel-sinewed boom that Washington has been promising. In fact, I feel that we are probably going to have a struggling and sluggish business picture right through 1975 and perhaps a good portion of the Bicentennial (and election) year 1976.

With real assets of individuals down sharply over the last few years, with real buying power down to an eleven year low, the American consumer is showing the same preference that the corporations are showing, and that preference is for liquidity. In his June 6 "Comments on Credit" report, Dr. Henry Kaufman of Salomon Bros. notes that "Yet another economic indicator, real fixed investment, marks the current recession as the deepest since the late 1930's." He goes on to state that fixed investments (in terms of 1958 dollars) dropped 21% over the last three quarters, their steepest decline in both absolute and percentage terms since World War II.

Just as important, Dr. Kaufman reports that "Prospects for a quick and steep recovery in fixed investment are not imminent. While new investments in residential structures may be bottoming out, surveys of manufacturers indicate there is a large and still growing surplus of unused capacity. Moreover, two prominent surveys of manufacturer's intended capital spending plans for the current year have both been revised significantly downward for the second time."

All right, so where does that leave Richard Russell and all his readers? For one thing, it would seem to bear out my thinking about bonds and the money market. The way events are shaping up, I would say that the first big play in 1975 was the stock market. And (surprise!) the second big play is the money market. The fact is that over the past month money instruments (bills, notes, bonds) have been booming, and the momentum is still there. With each new day bringing forth a revision or a hedged statement from some previously all-out bullish economist ("The recession will definitely, or let me say probably, bottom out late in the third quarter or possibly around the fourth quarter"), the money markets have been taking the hint. Fat yields are "in" and the word is "lock 'em in" before they disappear.

On this page I have included my own rather rare chart (nobody seems to chart the daily price movement in the Treasury note market) of the Treasury 7-3/4 of 1981, a debt instrument which I recommended strongly in Letters 630 and 631. As you can see, the 7-3/4 note is now around 103 (actually, $1,030), up approximately 5 points ($50) from where I first suggested purchases. A subscriber who came in for say $100,000 of these notes at 98 is now looking at a $5,000 paper profit and 8% yield on his original purchase price. So far, so good.



On June 11 the bellwether 91-day Treasury bill provided a shock to the "crowding out" school (i.e., those who thought the Government would crowd out corporate bond sellers) as the yield on the bills broke under 5%. On the June 16 auction, the bill yields sank to 4.76%. This means lower yields and returns across the board, from bank C/D's to notes to bonds to banker's acceptances. My guess is that short-term yield seekers will now move out to the intermediate-term for yields, and intermediate-term yield seekers will fan out into the longer-term market.

In time, the broad decline in interest rates, spurred on by sinking bank loans and the steady expansion of the money supply, will exert a bullish effect on the closed-end bond funds (see Letter 631, page 6), and I will have more to say about these funds at the end of this Letter.

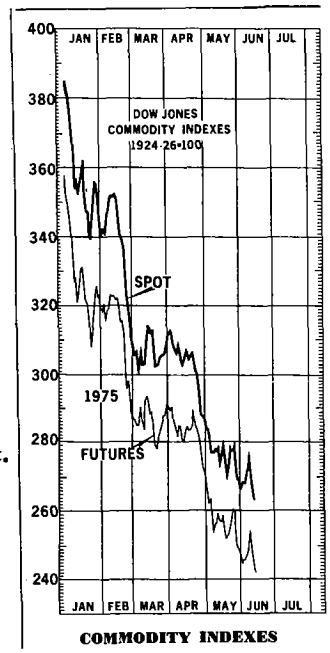
I have just finished reading the June 4 issue of Financial World, and in it there appears a most interesting bull-bear article. John Wright (Wright's Investor Service) takes the long-term bullish view, stating that we are at the beginning of a major bull market which could see "the Dow reach 1500 within five years." My friend Tom Holt (Holt Advisory) takes the bearish view. Holt expects the US economy to slump into a depression during the next year or so, a depression which may not bottom out until the late 1970's. Holt believes that bottom for the Dow "may be closer to 400" than 600 or 700.

I respect both of these veteran market observers, and I respect their views. But my own feeling is that we could be in a situation that may ultimately resemble the 1932-37 bull market. That was a most trying yet profitable period, which followed the 1929-32 catastrophe. During 1932 to '37 the basic problems were deflation, a collapse of the banking system, a total breakdown in confidence, and mass unemployment. During this dismal period, the Government showed itself singularly unable to return the nation back to prosperity. It took the giant production demands and huge deficits of World War II to accomplish that.

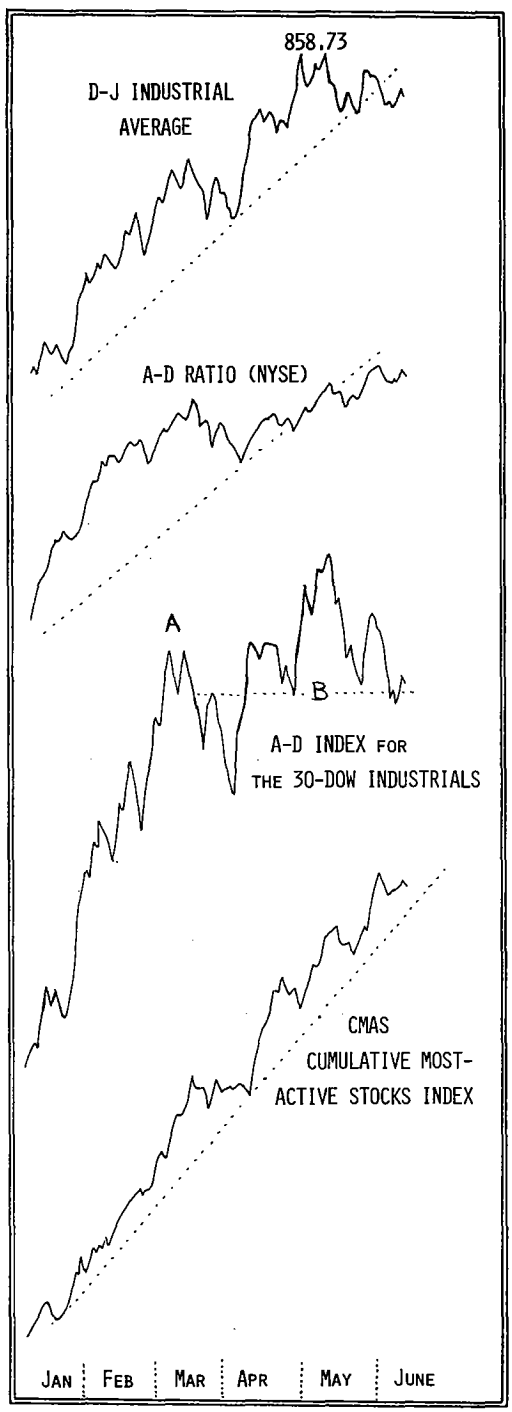
Today the problems are vastly different, but in some respects there are similarities. Confidence is fragile today but not smashed. Today the Government is willing to go to almost any ends to keep the economy going. These ends include a mammoth peace-time defense spending, huge deficits (at the risk of further eroding the dollar), selling the nation's gold reserves, increasing the money supply to almost any "required" rate, and greatly enlarging the welfare, unemployment and Social Security base.

Interestingly, both Wright and Holt (in the Financial World article) see no real inflation ahead. Wright states that "Inflation is dead for all practical purposes, so the Fed can safely increase the money supply to help spur business, augmenting more stimulative fiscal policies." Holt says "We are at the beginning of a depression," and it will be "the worst since the thirties."

From the look of the latest Wall Street Journal commodity chart, one can hardly say that price inflation is still rampant. Nevertheless, I would tend to disagree with Wright and Holt. I feel that the current liquidity build-up might last well into 1976. But with the money supply now rising at a 10% rate, with pension money accumulating at a fantastic rate, with consumers and corporations boosting their liquidity ratios, we will be moving toward the final period of super-inflation, a period in which all the pent-up forces now building will suddenly be unleashed. I am of the opinion that somewhere ahead (probably around the time when all the "experts" agree that inflation is over) we are going to plunge into a period which will represent the culmination of the whole inflationary cycle that began in 1932. It won't be pleasant, it won't be expected, it won't be manageable — but it's coming. The real problem, I believe, is what we as investors and survivors will do about it.



COMMODITY INDEXES



INDICATORS: People tend to have a misconception about stock market indicators, and this is probably the fault of the market analysts. Wall Street, after decades of ignoring technical analysis, started taking technical studies seriously around the late 1960's. More recently (since 1969), the institutions have been much more interested in the technical approach, since they reluctantly realized that only the technical approach called the 1969-74 bear market (to put it another way, if they had followed the technical approach the institutions would probably not have lost the billions that they did lose).

But we should understand that technical indicators do not necessarily offer any predictions regarding the future path of the market. More often, a technical indicator simply tells you what is actually happening, versus what "appears to be happening." In other words, a 50-point Dow advance can look great, but it can be dangerous. It all depends on how the technical underpinnings of the market stack up as the advance progresses.

The accompanying chart shows the Dow Industrials since January along with three indicators which I follow daily. Note that the advance-decline ratio (NYSE) moved up powerfully during the "buying stampede" of October to March 17. Then came the March decline. But the next phase of the A-D rally rise was much more sluggish and labored. By June 4 the A-D ratio struck a second peak for 1975, but this peak was only 1 point above the March 17 A-D peak. Even more important, the June peak was not confirmed by the Dow (the Dow hit its 1975 peak at 858.73 on May 14, three weeks prior to the A-D peak).

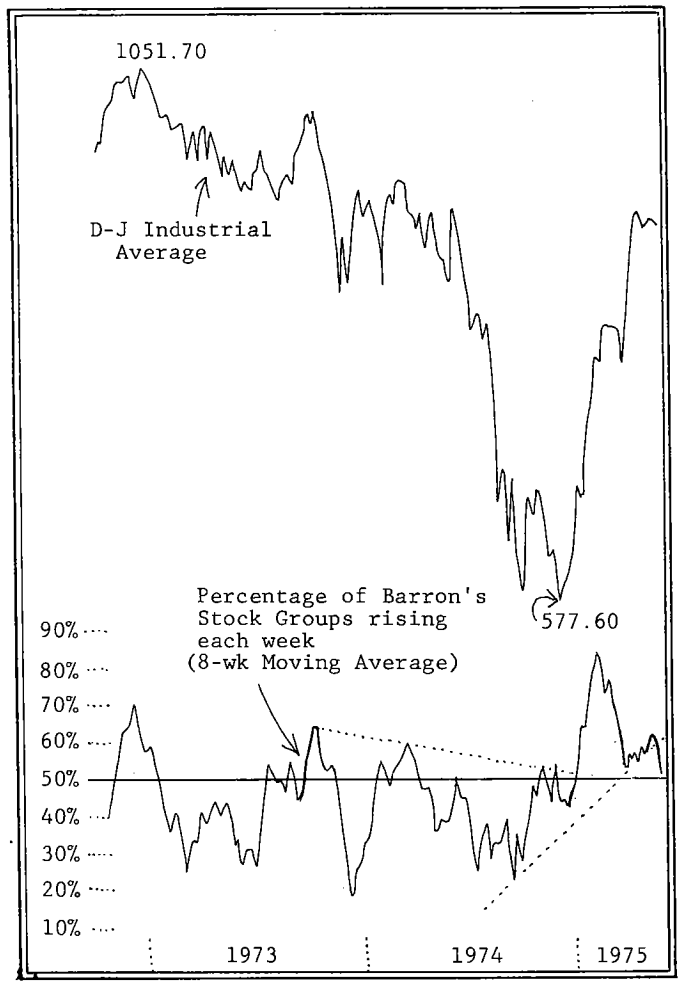
The next indicator is the A-D index for the 30-Dow stocks. As far as I know, no other market student keeps this index, but I consider it valuable. The Dow A-D index is a daily cumulative index of the plurality of advances or declines in the 30-Dow Industrials. What the Dow A-D shows is obviously the breadth in the Dow. By comparing the Dow and its own A-D index, we can see whether each successive advance or decline in the Dow is being fired by increased or decreased participation in the 30-Dow stocks.

Note that the first peak of strength in the Dow A-D came in March at the point marked A. The A-D plunged into late-March, then pushed to the May peak. But during April, May and June, Dow participation dropped off on the rallies and a head-and-shoulders top appeared. The support line is shown as the dashed line (labeled B). On June 12 the Dow A-D broke slightly below support line B, then rallied. Conclusion: The Dow A-D line is not keeping up with the Dow Average on the upside but is outperforming it on the downside. This means that fewer and fewer Dow stocks are doing the real work. That constitutes an emerging negative for the market.

The last indicator is the cumulative advance-decline index of the 15 most active stocks on the NYSE. This is the index which I have been saying is the strongest of all NYSE indicators. It is composed of the plurality of the 15 most active stocks (daily) as a running total. For instance, if 12 of the most actives rallied on a given day and 3 declined, the figure for the day would be plus 9, and this would be added to the previous day's total.

I have been saying that all technical eyes should now be glued to this indicator, because the place to watch during an "out-of-gear" market (as this one now is) is the index which will not reverse. When the strongest index does finally break, we usually have a good indication that the back of the advance is broken. As of now, the cumulative most active index (CMAS) is is still intact and holding above its trendline. It is telling us that the big (or active) money is still on the plus side of the market. If the trend of the most actives turns down on a trend basis, this market will head for lower levels. Until then, we will either be holding (consolidating) or pushing higher.

GROUPS: The study of stock groups is a fascinating and instructive one. The study is also basic to technical analysis. You can often "fool" the market with the action of individual stocks — but you can't fool the group studies. For instance, if General Foods suddenly goes wild on the upside the casual observer may believe that this is very bullish for all food processors. But if the group does not move up with General Foods, you can then conclude that something is right with GF alone, but it is not necessarily a fundamental plus for the Food Group. In other words, if a given group rises, you can generally infer that whatever is making the group rise will be bullish for all the stocks in that industry. But if a specific stock rises, the reasons for that rise may not be bullish for the rest of the group.



By the same token, when a majority of stock groups are rising, it is bullish for the market because we can infer that the movement is very broad — as opposed to, for instance, a lot of upside action in various and unconnected stocks. For this reason, I keep technical studies of group action, based on the weekly percentage of groups in advancing trends. For the statistics, I use Barron's Groups on the Laboratory Page (Golds are eliminated, since they usually move counter-trend). Each week I simply add the number of advancing groups. For instance, if 10 groups advanced on a given week, I divide this by 34 (the total number of groups) and arrive at 29.4% as the percentage of groups which advanced that week. This percentage is my latest entry on an 8-week moving average (I use a moving average to smooth out the statistics).

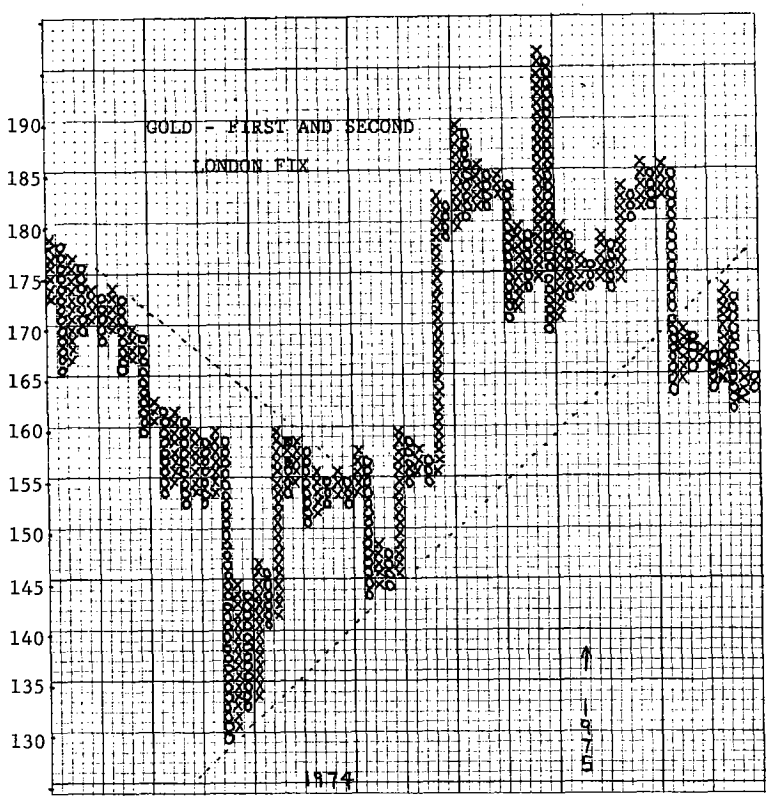
Referring to the chart, note that during the bear market years of 1973 and 1974 each peak on the groups advancing index was lower than the preceding peak. At the late-1972 peak, the chart shows 70% of the groups in advancing trends. The year 1973 produced a peak on the index of only 65%. In early 1974 we saw a peak for the index at 60%. Following the first positive peak of 1974, the index plunged into negative territory as the market crashed. Interestingly the low percentage for 1974 came as early as October 4 at 21% bullish. This low was 3% higher than the 18% low that was recorded in late-1973, a curious and perhaps hopeful indication.

From the October 4, 1974 low, the percentage of groups expanding index pushed steadily higher. On January 10 the index broke above the critical 50% level. Simultaneously the declining trendline connecting the 1973 and 1974 peak was bettered. The index continued up, hitting a 17 year high of 83% on February 21. From there the index declined to a low of 52% on April 4.

From the April low of 52%, the group bullish percentage advanced to a June 6 peak of 63%. But on the week ending June 13 only one of the 34 Barron's groups advanced, providing a one-week reading of only 3% bullish and dropping the eight-week moving average down to an uncomfortable 51% (note that at no time since January 10 has this index fallen below the critical 50% level).

The plunge of the last two weeks has served to break the rising trendline extending from the 1974 low, however, and this is a cause for concern. If this week's reading for the groups is poor (say 15% or less groups advancing), we would see the groups advancing percentage drop below the 50% level, a development which I would take (particularly following the breaking of the 1974-75 rising trendline) as a distinct danger signal. Conversely, a stubborn holding of this index above 50% should be taken as a decided plus for the stock market.

GOLD: The dollar (as I have been saying for months) is the most undervalued major currency in the world today. A dollar will buy more in this country than will a comparable amount of foreign currency in France, Germany, Italy, or any other developed nation. I expect that over the next year foreign investors will recognize this and be moving into the US money and bond markets. And from the "Now It Can Be Told" Dept. I see (Los Angeles Times, June 16) that the Arabs have purchased huge amounts of US securities through (you guessed it) the Swiss banks. The Treasury puts the figure at $11 billion; $6 billion in stocks, $4 billion in banks, $1 billion in bonds.



Ironically, with the OPEC nations going off the dollar and pegging their oil price to the SDR, a declining dollar will probably suit them fine. They know the dollar is undervalued, and if the dollar does decline (vs. the SDR), why the Arabs will just collect more dollars and wait for the big dollar rally (which is bound to come).

Of course, the reason the US wants to bury gold is clear enough. If they can get the world off gold, then the massive dollar overhand (dollars in foreign hands) will represent a call on nothing, nothing at all. Foreigners will sit with those dollars or spend them, but they won't set off a run on US gold. Thus, the US has a vested interest in making people believe that gold is just another commodity like hog bellies or zinc. Will they get away with it? Probably for a good while longer, but not forever.

But in this business I don't deal with "forever," I have to deal with the foreseeable future. So out comes my point & figure chart on gold, and I would have to say that the chart does not look too happy for gold. Having broken below the major trendline, gold rallied back up to the trendline (174 on the chart). A new decline took bullion down to the 162 box, providing a rather "unpleasant" situation which smacks of distribution.

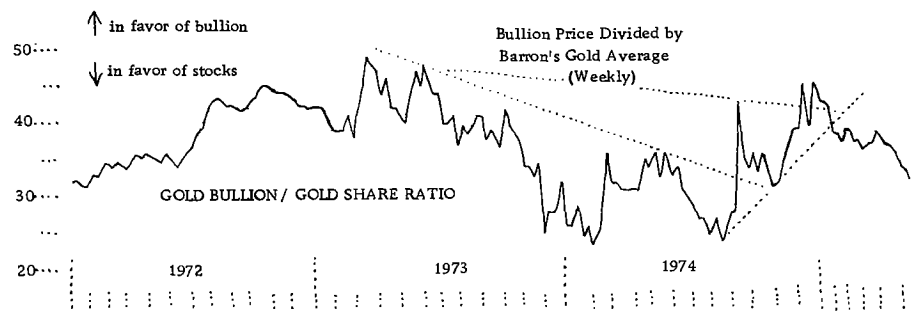
Technically, gold would have to hit 175 to remove the ominous look of the recent pattern. On the other hand, a price of 161 would, I believe, constitute the technical trigger that would push gold off the 160 cliff and down into the 150's or lower.

As I have been warning since late last year, the cost squeeze has been tightening around the mining industry. S. Africa has been making all sorts of concessions to the blacks, but when it comes to a choice between a political concession or a wage increase, you can bet they'll give the blacks the money. And that's why the mines have been under a double squeeze, lower gold prices and higher wages and costs. Canada isn't faring too much better, with creeping socialism and inflation now moving into the galloping stage.

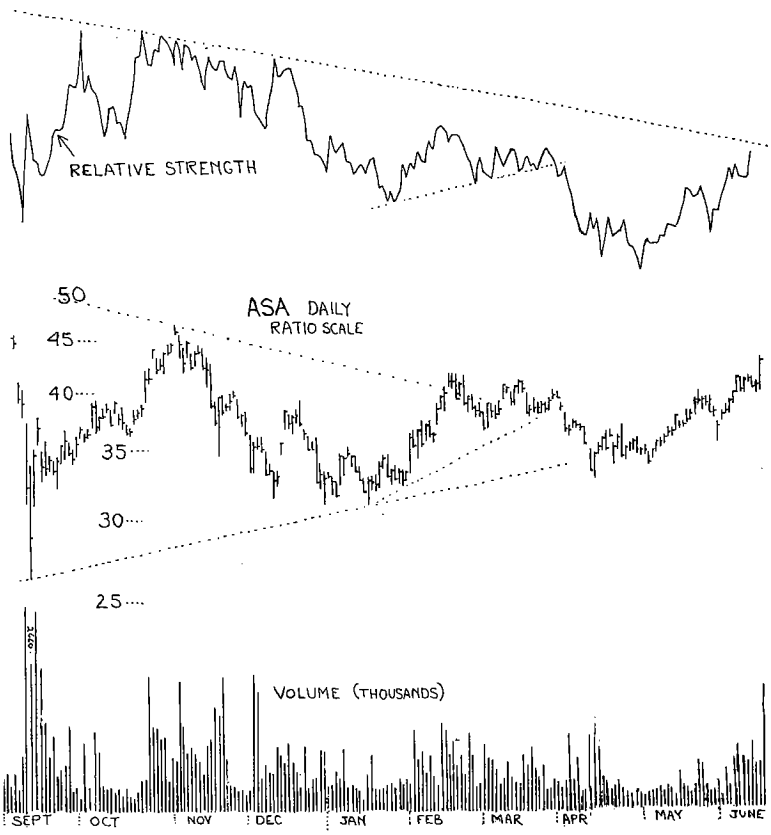
So that leaves us with an optional 15% in Krugerrands and Homestake as an inflation hedge. Or to introduce another thought, it leaves us with one foot in the golden door, just in case gold and gold shares take off and we want to average up.

My own feeling about gold is this: I think the pro-gold and anti-gold elements have just about cancelled each other out at this stage of the game. So suppose the unthinkable should occur (unthinkable for Wall Street, that is) — which is that no real trend or movement develops. It would not surprise me to see gold investments in a virtual stalemate for the remainder of 1975 and even well into 1976 (James Dines, forgive me) as the wage-price squeeze runs headlong into the inflationary upward pressures, netting a period of suspended animation for golds.

I am including my gold bullion/gold share ratio chart that shows which way the preference is going. As you can see, from August, 1974 to January, 1975, the preference was in favor of gold bullion over the shares as the ratio rose to 46. Since January, the preference has moved steadily back towards the shares, with the trend accelerating over the last few weeks. In fact, as you well



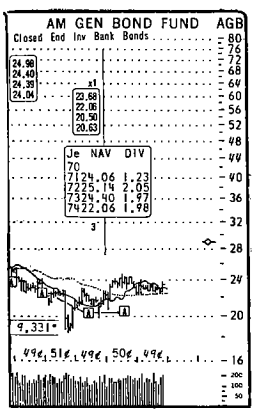
know, the shares of the listed golds such as Homestake and ASA have been moving up while gold has been doing little or nothing.

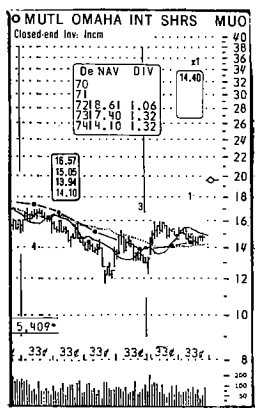


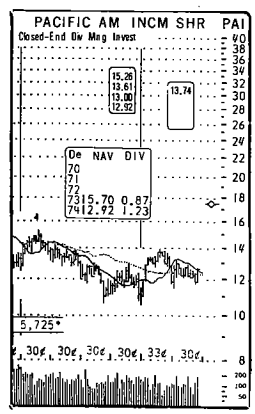
On this page I include my daily chart of ASA along with relative strength measured against the Dow. The split (2 for 1) stock has now bettered its February peak, thereby facing the next technical test which is the 46½ peak of last October. At the latest reading, ASA was selling at almost a 25% premium over the S. African gold shares which it owns, and this has not been a good sign in the past (unless, of course, we have a good rally in the S. African shares themselves). At any rate, the trend in ASA is up, and most interesting, its relative strength line is about to reverse a 10-month declining trend. This whole move since January has been most exotic, no volume, no excitement, nothin', but the stock is creeping up, it sure is.

BOND FUNDS: I receive many letters from people who need income, don't like to worry about safety, and can't find the immediate income they need in common stocks. The fact is that the average yield on S & P's broad 425 Industrials ranged from 3.29% at the high to 5.45% at the low. As of June 6, 1975 the 425 Industrials yields only 3.64%.

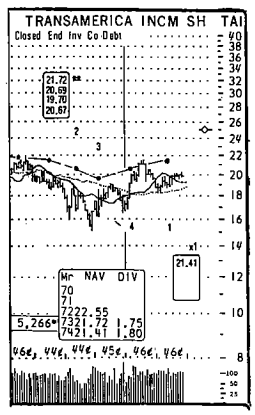
One place investors can go to get at least 120% more yield is the closed-end bond funds listed on the NYSE (see Letter 631). These funds are diversified, which provides a good degree of safety, and they provide fat yields. Most of the funds are now way below their former peaks, and the diamonds on the charts identify the previous all-time highs (for instance, TransAmerica's high was 25). Of interest to some people will be the fact that the four funds shown here pay dividends monthly. At the current price of 23.5, AGB yields (before purchasing commission) 8.3%, at 14-3/4 MUO yields 8.9%, at 13 PAI yields 9.5%, at 20-3/4 TAI yields 8.6%.

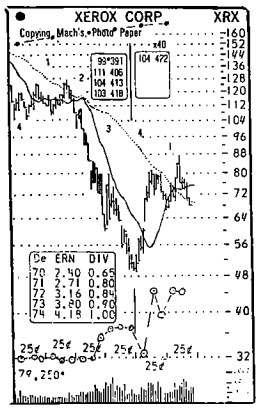






Most of these funds hold discounted bonds or bonds which were purchased below maturity prices. Although their net asset values are quoted at current market prices for their bond holding, the passage of time will exert an upward push on their assets as their bonds near maturity. In all, I feel that these bond funds can be held as long-term sources of income. The funds will, of course, fluctuate with interest rates, but their payout should tend to hold rather stable (charts courtesy of Quote Digest, Box 213, Wichita KS 67201).





XEROX: This stock has collapsed from the all-time high of 172 to the recent 67, a drop of 61% of its value! Yet this great company is moving into two fabulous fields, facsimile communications and high-speed printing. I have reason to believe that if what Xerox is doing comes to full fruition, communications as we know it now will someday be compared to the stone-age.

I know alot about Xerox, but not enough. The stock looks poor on the chart, a head-and-shoulder bottom just failed and the stock is now testing its April low. Earnings could be coming down, but that isn't the real story. Now I'm going to do something I've never done before. It's this — I'm going to ask any of my subscribers who have knowledge or ideas on the Xerox situation to drop me a line. Let's see if we can put the story together. It could help all of us, because I know when the puzzle is put together there's a tremendous story here.

LATE: On June 17 Transport Average broke below the 165.64 level, but no confirmation yet from Industrials. So the story is not yet told! Next mailing: July 1 (Letter 635).